

# **REPORT OF THE AUDITOR-GENERAL TO THE EASTERN CAPE PROVINCIAL LEGISLATURE AND THE COUNCIL ON THE O.R. TAMBO DISTRICT MUNICIPALITY**

## **REPORT ON THE CONSOLIDATED FINANCIAL STATEMENTS**

### **Introduction**

1. I have audited the accompanying consolidated and separate financial statements of the O.R. Tambo District Municipality, which comprise the consolidated and separate statement of financial position as at 30 June 2011, and the consolidated and separate statement of financial performance, statement of changes in net assets and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory information, as set out on pages XXX to XXX.

### **Accounting officer's responsibility for the consolidated financial statements**

2. The accounting officer is responsible for the preparation and fair presentation of these consolidated and separate financial statements in accordance with South African Standards of Generally Recognised Accounting Practice (GRAP) and the requirements of the Municipal Finance Management Act of South Africa, 2003 (Act No. 56 of 2003) (MFMA) and the Division of Revenue Act, 2010 (Act No. 1 of 2010 as amended) (DoRA), and for such internal control as management determines necessary to enable the preparation of consolidated and separate financial statements that are free from material misstatement, whether due to fraud or error.

### **Auditor-General's responsibility**

3. As required by section 188 of the Constitution of the Republic of South Africa, 1996 (Act No. 108 of 1996) and section 4 of the Public Audit Act of South Africa, 2004 (Act No. 25 of 2004) (PAA), my responsibility is to express an opinion on these consolidated and separate financial statements based on my audit.
4. I conducted my audit in accordance with International Standards on Auditing and General Notice 1111 of 2010 issued in Government Gazette 33872 of 15 December 2010. Those standards require that I comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated and separate financial statements are free from material misstatement.
5. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated and separate financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the consolidated and separate financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated and separate financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated and separate financial statements.
6. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my adverse audit opinion.

## **Basis for adverse opinion**

### **Infrastructure, property, plant and equipment, depreciation and amortisation and capital commitments**

7. The Standards of Generally Recognised Accounting Practice, GRAP 17: *Property, Plant and Equipment* states that the cost of an item of property, plant and equipment shall be recognised as an asset if it is probable that future economic benefits or service potential associated with the item will flow to the entity and the cost or fair value of the item can be measured reliably. These recognition criteria were not applied and hence items that qualify for recognition as an infrastructure, property, plant and equipment asset totalling R48.4 million were expensed and not capitalised. Had these items been recorded as assets, the surplus for the current period, accumulated surplus at the beginning of the year as well as infrastructure, property, plant and equipment would have increased and expenditure would have decreased by R48.4 million respectively.
8. GRAP 17: *Property, Plant and Equipment* states that where assets are carried at fair value, revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the reporting date. Land and buildings are accounted for using the fair value method per the accounting policy notes, but were not revalued to their fair value at 30 June 2011. Had these items been revalued, the land balance of R35.8 million and buildings balance of R66.9 million as disclosed in note 10 to the consolidated and separate financial statements would increase by R2.6 million and R4.7 million respectively. The reserves balance of R102.6 million as disclosed in the statement of financial position would increase by R7.3 million.
9. Additions to infrastructure, property, plant and equipment were recorded via a journal to reallocate assets from general expenditure to infrastructure, property, plant and equipment. This journal was recorded using the cost of the asset inclusive of Value Added Tax (VAT). Had these items been journalised exclusive of VAT as required, the surplus for the period, infrastructure, property, plant and equipment and accumulated surplus would have decreased by R16.3 million and general expenses would increase by R16.3 million.
10. GRAP 17: *Property, Plant and Equipment* states that depreciation of an asset begins when it is available for use. Infrastructure assets available for use with a carrying value of R152.2 million were recorded as capital work in progress and were not depreciated. I was unable to determine when these assets were available for use and what the increase in depreciation would be had these assets been depreciated. The municipality's records did not permit the application of alternative audit procedures.
11. The infrastructure, property, plant and equipment balance of R3.860 billion, as disclosed in note 10 to the consolidated and separate financial statements, does not agree to the balance of R3.763 billion per the underlying accounting records. Furthermore, the entity did not reconcile this difference of R97 million between the consolidated and separate financial statements and the underlying accounting records and could not provide sufficient appropriate audit evidence to support this amount.
12. The correction of error amounting to R123.3 million disclosed in note 10 and 33 to the consolidated and separate financial statements, which relates to a prior period error, was not properly supported by appropriate documentation. This amount was recorded as a debit to infrastructure work in progress and a credit to accumulated surplus which increased these respective balances. Due to the nature of the errors identified, there were no alternative procedures that could be applied to verify this amount.

13. The capital commitments balance of R580.5 million disclosed in note 36 to the consolidated and separate financial statements was not properly supported by appropriate documentation. The municipality's records did not permit the application of alternative audit procedures.
14. The qualifications above are as a result of a lack of an adequate system of control, on which I could rely, to ensure the existence, completeness, valuation and allocation of the infrastructure, property, plant and equipment assets disclosure, as well as the capital commitments disclosure. The municipality's records did not permit the application of alternative audit procedures regarding infrastructure, property, plant and equipment.
15. Consequently, I did not obtain all the information I considered necessary to satisfy myself as to the existence, completeness, valuation and allocation of the infrastructure, property, plant and equipment assets balance of R3.860 billion (2009/10: R3.542 billion) as disclosed in note 10 to the consolidated and separate financial statements, the depreciation and amortisation balance of R138.5 million (2009/10: R138 million) as disclosed in the statement of financial performance, the capital commitments balance of R580.5 million (2009/10: R725.7 million) as disclosed in note 36 to the consolidated and separate financial statements and the accumulated surplus of balance of R3.784 billion (2009/10 R3.326 billion).

#### **General expenses and repairs and maintenance**

16. In terms of GRAP 17: *Property, Plant and Equipment*, the cost of an item of property, plant and equipment shall be recognised as an asset if it is probable that future economic benefits or service potential associated with the item will flow to the entity and the cost or fair value of the item can be measured reliably. Items that qualify for recognition as an infrastructure, property, plant and equipment asset totalling R48.4 million were expensed. Had these items been recorded as assets, general expenses and repairs and maintenance as disclosed in the statement of financial performance would have decreased by R37.5 million and R10.9 million respectively.

#### **Revenue from exchange transactions**

17. The water service charges revenue balance of R94.6 million as disclosed in note 17 to the consolidated and separate financial statements was not calculated and recorded using the approved tariff structure. Had the correct tariff structure been used, the revenue from exchange transactions and debt impairment expense as disclosed in the statement of financial performance would have decreased by R9 million. In addition, the gross trade receivables from exchange transactions and allowance for impairment losses as disclosed in note 6.1 to the consolidated and separate financial statements would have decreased by R9 million.
18. In addition, the municipality did not implement the indigents policy, nor were there controls in place to ensure that all water consumed is billed and recorded. The entity's records did not permit the application of alternative audit procedures in order to obtain reasonable assurance that all service charges revenue was completely recorded.
19. Consequently, I was unable to obtain sufficient appropriate audit evidence to satisfy myself as to the completeness of service charges revenue of R106 million (2009/10: R88.9 million) as disclosed in the statement of financial performance and note 17 to the consolidated and separate financial statements.

### **Gain on sale of assets**

20. The municipality did not have adequate records, systems and controls to account for the gain on sale of biological assets on which I could rely for the purpose of my audit, and there were no satisfactory audit procedures that I could perform to obtain reasonable assurance that all biological asset sales were recorded. Consequently, I was unable to obtain sufficient appropriate audit evidence to satisfy myself as to the completeness of the gain on sale of assets balance of R2.2 million as disclosed in the statement of financial performance and note 28 to the consolidated and separate financial statements.

### **Irregular expenditure**

21. Section 112 of the MFMA requires the entity to implement and maintain an appropriate procurement and provisioning system which is fair, equitable, transparent, competitive and cost-effective. Payments amounting to R321 million were made in contravention of the supply chain management policy. The amount was not identified by management and was not included in irregular expenditure, disclosed in note 42.2 to the consolidated and separate financial statements, resulting in irregular expenditure being understated by R321 million.
22. In addition, sufficient appropriate audit evidence could not be obtained to satisfy myself that contracts to the value of R41.6 million were procured in accordance with legislative requirements and the SCM policy. The municipality's records did not permit the application of alternative audit procedures. Consequently, I was unable to satisfy myself as to the completeness of irregular expenditure as disclosed in note 42.2 to the consolidated and separate financial statements.

### **Water distribution losses**

23. The municipality did not have adequate systems and controls to measure and monitor distribution losses. The water distribution losses amounting to R44.9 million (2009/10: R15 million) as disclosed in note 43 to the consolidated and separate financial statements were not supported by appropriate documentation and calculations. Consequently, I was unable to obtain sufficient appropriate audit evidence to satisfy myself as to the completeness and occurrence of the water distribution losses of R44.9 million (2009/10: R15 million) disclosed in note 43 to the consolidated and separate financial statements.

### **Other corresponding figures**

24. The auditor's report on the consolidated financial statements for the year ended 30 June 2010 contained a qualification paragraph due to a limitation on the scope on the audit of expenditure and therefore the possibility of irregular expenditure incurred. The matter which gave rise to the limitation, as described below, remains unresolved in the current year.
25. The municipal entity, Ntinga O.R. Tambo Development Agency, could not provide sufficient appropriate audit evidence regarding proof of delivery of goods or receipt of services and evidence of approval of expenditure of R51.4 million included in the prior year total expenditure balance of R984.9 million as disclosed in the consolidated statement of financial performance. This limitation on the scope of my work was imposed by a fire which destroyed expenditure vouchers in the prior year. I was unable to confirm or verify these amounts by alternative means and as a result, could not confirm the occurrence and compliance of the abovementioned amounts included in the corresponding figures.



**Adverse opinion**

26. In my opinion, because of the significance of the matters described in the basis for adverse opinion paragraphs, the consolidated and separate financial statements do not present fairly the financial position of the O.R. Tambo District Municipality as at 30 June 2011 and its financial performance and cash flows for the year then ended, in accordance with the GRAP reporting framework and the requirements of the MFMA.

**Emphasis of matters**

I draw attention to the matters below. My opinion is not modified in respect of these matters:

**Restatement of corresponding figures**

27. As disclosed in note 33 to the consolidated and separate financial statements, the corresponding figures for 30 June 2010 have been restated in the consolidated and separate financial statements of the O.R. Tambo District Municipality as a result of errors discovered during the current year.

**Unauthorised expenditure**

28. As disclosed in the note 42.3 to the consolidated and separate financial statements, unauthorised expenditure to the amount of R7.2 million was incurred as the actual expenditure exceeded the budgeted amount on certain votes for which approval was not obtained.

**Irregular expenditure**

29. As disclosed in the note 42.2 to the consolidated and separate financial statements, irregular expenditure of R4.39 million was incurred as the expenditure incurred was in contravention of Supply Chain Management (SCM) regulation 12(1)(c) and 17(a).

**Fruitless and wasteful expenditure**

30. As disclosed in the note 43.1 to the consolidated and separate financial statements, the municipality incurred fruitless and wasteful expenditure of R 419 050 relating to payments for goods and services that were never received.

**Material losses / Impairments**

31. As disclosed in note 6.2 to the consolidated and separate financial statements, the municipality impaired its current year and prior year debtors by an amount of R195 million and R163 million respectively. This impairment is necessary due to poor collection practices and non-implementation of policies.

**Material underspending of the budget**

32. As disclosed in note 45 to the consolidated and separate financial statements, the municipality has materially underspent on its budget. At the year end, the underspending amounted to R234 million (2010: R164 million) and no satisfactory explanation was provided. The majority of this relates to other expenditure, which includes conditional grant expenditure. This results in targets not being achieved and poor service delivery.

**Additional matter**

I draw attention to the matter below. My opinion is not modified in respect of this matter:

### **Unaudited supplementary schedules**

33. The supplementary information in the appendices set out on pages XXXX to XXXX do not form part of the consolidated and separate financial statements and is presented as additional information. I have not audited these schedules and accordingly I do not express an opinion thereon.

### **REPORT ON OTHER LEGAL AND REGULATORY REQUIREMENTS**

34. In accordance with the PAA and in terms of General notice 1111 of 2010, issued in Government Gazette 33872 of 15 December 2010, I include below my findings on the annual performance report as set out on pages XXX to XXX and material non-compliance with laws and regulations applicable to the municipality.

#### **Predetermined objectives**

##### **Usefulness of information**

35. The following criteria are relevant to the findings below:

- **Consistency:** Objectives, indicators and targets are consistent between planning and reporting documents.
- **Relevance:** A clear and logical link exists between the objectives, outcomes, outputs, indicators and performance targets.
- **Measurability:** Indicators are well-defined and verifiable, and targets are specific, measurable and time-bound.

36. Audit findings:

- **Reported indicators are not complete when compared with the planned indicators**  
The actual achievements with regard to 37% of all planned indicators specified in the integrated development plan for the year under review were not included in the report on predetermined objectives submitted for audit.
- **Reported information is not consistent when compared with the planned indicators**  
Of the reported information reviewed, 38% of the planned objectives, 68% of all planned indicators and 29% of the planned targets specified in the integrated development plan for the year under review were not consistent with the information reported in the report on predetermined objectives submitted for audit purposes.
- **Planned and reported performance targets are not measurable**  
Targets with regard to 38% of all planned indicators specified in the integrated development plan are not measurable and specific.

##### **Reliability of Information**

37. The following criteria are relevant to the findings below:

- **Validity:** Actual reported performance has occurred and pertains to the entity.
- **Accuracy:** Amounts, numbers, and other data relating to reported actual performance have been recorded and reported appropriately.

### 38. Audit findings:

- **Reported results per the annual performance report are not valid as no supporting source information was provided**

For the selected targets the validity of 27% of the reported indicators could not be established as sufficient appropriate audit evidence could not be provided for audit purposes.

- **Reported results per the annual performance report are not accurate when compared to source information**

For the following material reported indicators the source information or evidence provided was not accurate:

- The reported number of water schemes refurbished and upgraded is not accurate as 70% of the reported performance did not agree to supporting documentation.
- The reported number of households benefiting from the One Household One Food Garden programme is not accurate as 47% of the reported performance did not agree to supporting documentation.

### **Compliance with laws and regulations**

Included below are findings on material non-compliance with laws and regulations applicable to the municipality.

#### **Budgets**

39. The municipality incurred expenditure in excess of the limits of the amounts provided for in the votes in the approved budget, in contravention of section 15 of the MFMA.
40. The accounting officer did not always submit the monthly budget statements to the relevant provincial treasury, as required by section 71(1) of the MFMA.

#### **Annual financial statements, performance and annual reports**

41. The financial statements submitted for auditing were not prepared in all material respects in accordance with the requirements of section 122 of the MFMA. Material misstatements of capital assets, revenue, expenditure and disclosure identified by the auditors were subsequently corrected, but the uncorrected material misstatements resulted in the financial statements receiving an adverse audit opinion.
42. The accounting officer did not make public the council's oversight report on the 2009/10 annual report within seven days of its adoption, as required by section 129(3) of the MFMA.

#### **Internal audit**

43. The internal auditors of the municipality did not audit the performance measurements on a continuous basis as required by Municipal Planning and Performance Management Regulation 14.

### **Expenditure management**

44. Money owing by the municipality was not always paid within 30 days of receiving an invoice or statement, as required by section 65(2)(e) of the MFMA.
45. The accounting officer did not take all reasonable steps to ensure that the municipality had and maintained a management, accounting and information system which recognised expenditure when it was incurred, accounted for creditors of the municipality and accounted for payments made by the municipality as required by section 65(2)(b) of the MFMA.
46. The accounting officer did not take reasonable steps to prevent unauthorised expenditure, irregular expenditure and fruitless and wasteful expenditure, as required by section 62(1)(d) of the MFMA.

### **Procurement and contract management**

47. Goods and services with a transaction value of between R10 000 and R200 000 were procured without obtaining written price quotations from at least three different prospective providers as per the requirements of SCM regulation 17(a) and (c).
48. Goods and services of a transaction value above R200 000 were procured without inviting competitive bids as per the requirements of SCM regulation 19(a) and 36(1).
49. Invitations for competitive bidding were not always advertised for a required minimum period of days as per the requirements of SCM regulation 22(1) and 22(2).
50. Awards were made to providers whose tax matters had not been declared by the South African Revenue Services to be in order as required by SCM regulation 43.
51. Awards were made to suppliers who did not submit a declaration on their employment by the state or their relationship to a person employed by the state as per the requirements of Municipal SCM regulation 13(c).
52. The preference point system was not applied in all procurement of goods and services above R30 000 as required by section 2(a) of the Preferential Procurement Policy Framework Act (PPPFA) and SCM regulation 28(1)(a).
53. Sufficient appropriate audit evidence could not be obtained that construction contracts were awarded to contractors that were registered and qualified for the contract in accordance with the prescripts of the Construction Industry Development Board (CIDB).
54. Awards were made to providers who are persons in service of other state institutions in contravention of the requirements of SCM regulations 44. Furthermore the provider failed to declare that he/she is in the service of the state as required by SCM regulation 13(c).
55. Persons in service of the municipality who had a private or business interest in contracts awarded by the municipality failed to disclose such interest, as required by SCM regulation 46(2)(e).
56. A list of accredited prospective providers was not in place for procuring goods and services through quotations as required by SCM regulation 14(1)(a).



### **Human resource management and compensation**

57. Senior managers directly accountable to the municipal manager did not sign annual performance agreements for the year under review, as required by sections 57(1)(b) and 57(2)(a) of the Municipal Systems Act (MSA).
58. The acting municipal manager did not sign an annual performance agreement for the year under review, as required by sections 57(1)(b) and 57(2)(a) of the MSA.

### **Transfer of funds and conditional grants**

59. The municipality did not always submit quarterly reports to the transferring national officer on non-financial performance in respect of the allocation received as required by section 11(2)(c) of the DoRA.
60. The accounting officer did not evaluate the performance of the municipality in respect of programmes funded or partially funded by a schedule 4 allocation within two months after the end of the financial year as required by section 11(6) of the DoRA.

### **Revenue management**

61. A credit control and debt collection policy was not implemented as required by section 96(b) of the MSA.

### **Asset management**

62. The accounting officer did not take all reasonable steps to ensure that the municipality had and maintained a management, accounting and information system which accounts for the assets of the municipality as required by section 63(2)(a) of the MFMA.
63. The accounting officer did not take all reasonable steps to ensure that the municipality had and maintained an effective system of internal control for assets (including an asset register) as required by section 63(2)(c) of the MFMA.

## **INTERNAL CONTROL**

64. In accordance with the PAA and in terms of General notice 1111 of 2010, issued in *Government Gazette 33872 of 15 December 2010*, I considered internal control relevant to my audit, but not for the purpose of expressing an opinion on the effectiveness of internal control. The matters reported below are limited to the significant deficiencies that resulted in the basis for adverse opinion, the findings on the annual performance report and the findings on compliance with laws and regulations included in this report.

### **Leadership**

65. There has been a significant change in leadership during the year in that a new Council and Mayor were appointed after the elections. The lack of oversight and accountability of the accounting officer, senior management officials and Council has resulted in numerous repeat audit findings.
66. The accounting officer and council have failed to ensure that the Human Resources unit manages the staffing requirements within the department through the appointment and retention of adequate and sufficiently skilled resources within an updated and approved operational organisational structure. As a result, the municipality does not appear to be sufficiently staffed in order to ensure the fair presentation of financial statements and reporting on predetermined objectives and compliance with laws and regulations.

67. The municipality did not have adequate controls and processes in place to ensure compliance with all applicable legislation. Further, there is inadequate oversight by senior officials to ensure that policies, procedures and controls are implemented correctly.

#### **Financial and performance management**

68. The finance department remains reliant on the use of consultants to perform functions that should be performed by the staff employed by the municipality. A poor control environment over financial reporting exists as extensive manual reconciliation of accounting records and supporting schedules is required at year end as these controls are not performed on a regular ongoing basis during the year. In addition, controls are not designed to prevent and detect irregular expenditure.
69. The annual financial statements submitted for audit were subject to numerous amendments to ensure achievement of adequate presentation. Further, not all documentation requested for the auditing of a number of balances disclosed in the financial statements, as well as assessing actual performance against predetermined objectives, was provided for audit purposes. The systems or processes for the preparation and reporting of performance against predetermined objectives are not adequate or sufficient as the department has no formally adopted, and tailored, system or procedure manual which sets out processes to follow, controls in place, as well as responsible officials for the preparation, collation, reporting and monitoring of performance against predetermined objectives. In addition, managers do not always submit the required reports and supporting documentation for monitoring purposes.
70. The municipality does not have adequate controls in place over significant operational areas such as infrastructure, property, plant and equipment, revenue and accounts receivable as not all transactions are identified and recorded in the accounting records. Further, there is a lack of segregation of duties as reliance is placed on a few key personnel to perform crucial functions. This has the impact of limiting supervision and monitoring.

#### **Governance**

71. Insufficient action was taken by the governance structures within the municipality to ensure that risks relating to the monitoring and reporting of financial information as well as performance objectives were addressed. Management did not implement all the recommendations made by internal and external audit which resulted in repeat audit findings in these areas.
72. In addition, the audit committee and internal audit unit failed to identify and provide sufficient oversight relating to the supply chain management processes resulting in a significant increase in irregular expenditure identified through the audit process in the current year. Although a review of the supply chain management process was performed by the internal audit unit, it was not sufficient as it did not identify all weaknesses, resulting in unidentified and undisclosed irregular expenditure. There was also insufficient monitoring by those charged with governance to ensure compliance with laws and regulations.

## OTHER REPORTS

### Investigations

73. A number of investigations are in progress. The investigations were initiated based on the allegation of possible conflicts of interest, irregularities in the awarding of bids, non compliance with the supply chain management policy, misappropriation of assets and fraud. The investigations resulted in criminal proceedings being instituted against four employees.

*Auditor-General.*

East London

15 December 2011



AUDITOR-GENERAL  
SOUTH AFRICA

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